IAWC Exhibit 4.0SR

ILLINOIS-AMERICAN WATER COMPANY

SURREBUTTAL TESTIMONY

OF

JOSEPH F. HARTNETT, JR.

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Q. Please state your name and business address.

A. Joseph F. Hartnett, Jr., American Water Works Company, Inc., 1025 Laurel Oak Road, Voorhees, NJ 08043.

Q. Are you the same Joseph F. Hartnett, Jr. who testified previously in this proceeding?

A. Yes.

Q. What is the purpose of your Surrebuttal Testimony?

A. My Surrebuttal Testimony will respond to the Rebuttal Testimony of Ms. Langfeldt and Mr. Gorman.

Q. At page 4, Ms. Langfeldt states, "therefore, if the Company would not have a reasonable opportunity to recover its investment without resort to charging ratepayers for an inflated estimate of the merger premium, then it agreed to pay too much for the utility assets." Is Ms. Langfeldt's position a reasonable one?

A. No. IAWC's proposal does not increase charges to ratepayers to pay for the Acquisition Premium. (I understand Ms. Langfeldt's reference to "merger premium" to mean the Acquisition Premium.) Under the Savings Sharing Proposal, the Acquisition Revenue Requirement is paid from the shareholders' portion of Demonstrated Savings. The customers' portion of Demonstrated Savings operates to reduce the cost of service. Thus, under the Savings Sharing Proposal, rates would be lower than they would be, absent the Acquisition. If IAWC does not have a reasonable opportunity to recover its investment in the Acquisition by retaining a portion of the Demonstrated Savings, then IAWC does not believe Section 7-204 will be satisfied.

Q. Is Ms. Langfeldt correct in stating at page 9, beginning at line 170, that "There is no logical basis for the Company to assume that the ratepayers would be charged for a premium that has no effect on merger savings and which resulted from negotiations in which ratepayers did not participate."

A. As I have explained, the Savings Sharing Proposal operates to reduce rates and, at the same time, provide shareholders with an opportunity to recover the Acquisition Revenue Requirement. The Acquisition results in lower rates and better service. Furthermore, recovery of the Acquisition Revenue Requirement is necessary to provide an economic justification for the Acquisition to occur with no risk or cost incurred by the customers. Further as discussed by several Company witnesses, the premium not only has an "effect" on "merger savings"; but the savings could not be generated, absent the Acquisition; and the Acquisition would not occur without payment of the premium; so that it is the premium which actually allows the savings to be generated.

Q. At page 11, beginning at line 210, Ms. Langfeldt states, "[i]n future acquisitions, premiums could increase due to the recognition of premium in utility rates in previous cases since acquirers would have certainty of premium recovery. As a result, savings net of the premium would decrease." Is this testimony accurate?

A. It is not likely that acquisition premiums would increase if the Savings Sharing Proposal is approved. As has been discussed, under the Savings Sharing Proposal, the shareholders bear all risk that the Acquisition Revenue Requirement will not be recovered. Thus, there is no incentive at all for the shareholders to increase the burden of the Acquisition Revenue Requirement by agreeing to pay an unnecessarily high price (or premium). Approval of the Savings Sharing Proposal does not provide certainty that the Acquisition Premium will be recovered; nor would approval create certainty of recovery in any future case.

Q. At page 12, beginning at line 229, Ms. Langfeldt states that "Gross PP&E is not a proper method for allocating the purchase price of the project because it does not incorporate the present value of cash flows, including merger savings of each CUC company IAWC will acquire." Is this a valid criticism of the use of the Gross PP&E allocator?

A. No. Given the nature of an asset purchase transaction, the original cost of the assets (gross PP&E) is the most logical basis to use to allocate the project price. Moreover, as I will discuss, the price assigned to the Illinois Utility Assets is independently supported by the Illinois DCF Analysis shown on IAWC Exhibit 4.1R.

Q. At page 13, beginning at line 263, Ms. Langfeldt suggests that she immediately recognizes three problems with the Illinois/DCF analysis presented with your Rebuttal Testimony. Would you comment on these criticisms?

A. Yes. I believe Ms. Langfeldt's first objection relates to the mechanics of allocation rather than the Illinois DCF Analysis which supports the Illinois purchase price. Ms. Langfeldt is wrong in saying the Tax Benefits from the premium are not included in the project DCF. As stated in my response to Data Request RL 8.02, the DCF Analysis was updated to reflect the Tax Benefits (see RL 8.02 attachment slides 2 & 3) during our negotiations with Citizens. Finally Ms. Langfeldt states the savings are not the same as presented in IAWC Exhibit 3.1R. This was clearly explained in the response to Data Request RL 8.04. The synergies used in the DCF analysis were the preliminary synergies identified during pre-offer due diligence. Additional data was made available after the offer and such additional data was reflected in Exhibit 3.1R. The savings used for the DCF Analysis are the same savings as are included in attachment 4(c)-12 to Staff Data Request 1.02. As a result, the Illinois DCF Analysis is consistent with the total project DCF Analysis.

Q. At page 15, beginning at line 286, Ms. Langfeldt suggests that, "to properly allocate the purchase price of the utility assets, it would be necessary to calculate the ratio of the [p]roject's purchase price to its post-acquisition market value." ***Is this testimony correct?***

A. No, I disagree. This is a mathematical exercise that is not relevant to any issue before the Commission. The issue is whether the Illinois ratepayers would be subsidizing non-utility operations. The Illinois DCF Analysis clearly indicates the Illinois cash flows ($221 million) support the Illinois utility purchase price ($219 million). Further calculations are not relevant or necessary.

Q. Is Ms. Langfeldt correct in suggesting at the top of page 16, beginning at line 305, that "[d]ue to Mr. Bobba's limited knowledge of the details involved in the [merger and acquisitions] transactions he highlights in Company Exhibit 6.3 and the vague nature of acquisition multiples, Mr. Bobba's analysis is not sufficient for demonstrating the purchase price of the Utility Assets is ***reasonable in light of recent market data?***

A. It is important to remember the purpose of the comparison prepared by Mr. Bobba of recent acquisition market data. The Company determined the value of the Acquisition using a DCF methodology. However, as a further check of the reasonableness of the DCF results, Mr. Bobba compared the DCF valuation results to the values of similar transactions in the market. Mr. Bobba's methodology is entirely adequate to evaluate the DCF valuation results.

Q. At page 20, beginning at line 3, Mr. Gorman says you disagree with his conclusion that "IAWC is paying a premium to typical water utility stock valuations." Is this testimony correct?

A. No, I did not say that. I disagreed with Mr. Gorman's testimony on how to calculate the premium over the market value of CUCI prior to the Acquisition. In fact, attachment 4(c)-12 to Staff Data Request 1.02 clearly indicates where water utility stocks were trading at the time of our negotiations and where buyers were valuing water companies.

Q. On page 21, beginning on line 4, Mr. Gorman states that you contend that CUCI's valuation should not be based on public company stock valuations. Is this correct?

A. No. In fact, I agree that one should start with public company valuations. However, these valuation multiples must then be adjusted in order to apply them to CUCI. For example, Mr. Gorman uses a price to earnings (PE) multiple to value CUCI prior to the Acquisition. The average PE multiple for the publicly traded water companies are based on the earnings of those companies, which is after interest expense. CUCI's earnings used in Mr. Gorman's calculation show no interest expense, therefore overstating the earnings he is using. The ICC regulates CUCI based on an imputed capital structure, which lowers earnings to reflect significant imputed interest expense.

Another example of an adjustment needed to the public company PE multiples was to remove the portion attributable to acquisition speculation. By using a PE multiple that is inflated above the average historical PE multiples for water companies, Mr. Gorman is overstating the value of CUCI in calculating his proposed premium included in our purchase price. Mr. Gorman also refers to Mr. Bobba's testimony regarding similar financial ratios. Mr. Bobba, however, does not use the PE multiple as an appropriate valuation tool for an asset valuation multiple in his exhibits.

Q. On page 21 starting on line 8, Mr. Gorman refers to the "Asset and Stock Purchase Agreement" as evidence that the "agreement to acquire CUCI appears to be based on an asset and stock purchase." Is this correct?

A. No. As a point of clarification only, CUCI is the Illinois utility company, and the Acquisition of CUCI is strictly an asset purchase. The only stock that would be purchased in this transaction is the stock of Citizens Lake Water Company which is being purchased by AWW (or a non-regulated subsidiary) and <u>not</u> IAWC.

Q. Does this conclude your Surrebuttal Testimony?

A. Yes, it does.